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Nicholas Bagley: The federal role in subprime mortgage mess

By Nicholas Bagley

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As the federal government scurries to prevent the subprime mortgage crisis from sending the economy into a deep recession, people are asking why it waited so long to intervene. But, in fact, a few years ago an obscure federal agency torpedoed legislation from a handful of states that would have made institutional investors far more chary of buying mortgages that were likely to fail. If the legislation had been permitted to take effect, the crisis we now face would probably look a lot less grim.

Historically, few lenders would give mortgages to borrowers with poor credit. The risk of default was simply too great. During the 1990s, however, major institutional players became more willing to purchase subprime loans as investments. Those loans would be pooled with similar loans, and slices of that pool were bought and sold as mortgage-backed securities.

The ready flow of capital from the secondary mortgage market led to an explosion in subprime lending. Unscrupulous lenders could reap the greatest profits by issuing subprime loans packed with unfavorable terms and then selling them for cash. A rash of borrowers found themselves saddled with predatory loans they had no hope of paying off.

To combat this surge in predatory lending, some state legislatures decided to stanch the flow of easy credit to subprime lenders. In 2002, Georgia became the first state to tell players in the secondary mortgage market that they might be on the hook if they purchased loans deemed "predatory" under state law. Before, downstream owners of mortgage-backed securities might see the value of their investments drop, but that was generally the worst that could happen. Under the Georgia Fair Lending Act, however, players in the secondary mortgage market could face serious liability if they so much as touched a predatory loan.

The secondary market has an extraordinarily difficult time distinguishing predatory loans (bad) from appropriately priced subprime loans (good). Even if the line could be drawn with confidence, the market lacked the resources to gather the necessary information. As the then-General Accounting Office noted in its comprehensive review of predatory lending legislation in January 2004, "even the most stringent efforts cannot uncover some predatory loans."

Inevitably, the secondary mortgage market in Georgia's subprime loans ground to a halt. And that was the point: If buyers couldn't satisfy themselves that the loans weren't predatory, they should take their money elsewhere. Georgia legislators understood that impeding the capital flow to subprime loans might raise the cost of borrowing for some with poor credit but judged that this was more than balanced by protecting the most vulnerable from the scourge of predatory lending.

New York, New Jersey and New Mexico made the same call and within two years had enacted their own versions of laws exposing downstream owners of loans to fines if they bought predatory loans.

Enter the feds. Some of the biggest players in the secondary mortgage market are national banks, and the states' efforts to curb predatory lending clashed with banks' fervent desire to keep the market rolling. So the banks turned to the Treasury Department's Office of the Comptroller of the Currency. The primary regulatory responsibility of the OCC is ensuring the safety and soundness of the national bank system, but almost its entire budget comes from fees it imposes on banks, which have the option of incorporating under state law. Put another way, the agency's funding depends on keeping the banks happy. Little surprise, then, that the OCC acted when the national banks asked it to preempt subprime-mortgage laws such as Georgia's, arguing that they conflicted with federal banking law.

Despite the banks' thin legal arguments, the OCC issued regulations in early 2004 nullifying the state laws as they applied to national banks. The agency reasoned in part that the states just got it wrong.

As the then-comptroller explained in a 2003 speech: "We know that it's possible to deal effectively with predatory lending without putting impediments in the way of those who provide access to legitimate subprime credit."

With the state laws nullified, national banks and their subsidiaries were free to engage in the practices the states were hoping to stamp out. (Indeed, Georgia scuttled its law because it didn't want to give national banks a competitive advantage over its state institutions.)

Facing pressure from subprime lenders and Wall Street, and left without a real chance of holding investors responsible for purchasing ill-advised loans, state legislatures gave up on trying to meaningfully expose downstream buyers to liability for facilitating predatory lending.

In retrospect, the OCC's decision looks wrongheaded. What the agency took to be shortsighted consumer protection laws laden with hidden costs turned out to be prescient market-corrective reforms.

It's impossible to know for sure, but had the state laws been permitted to go into effect, investors would probably be sitting on fewer subprime loans that will never be repaid.

The feds ignored the basic principle that no level of government has a monopoly on good policy. As federal officials move to clean up the subprime mess, it's worth remembering that they helped to create it.